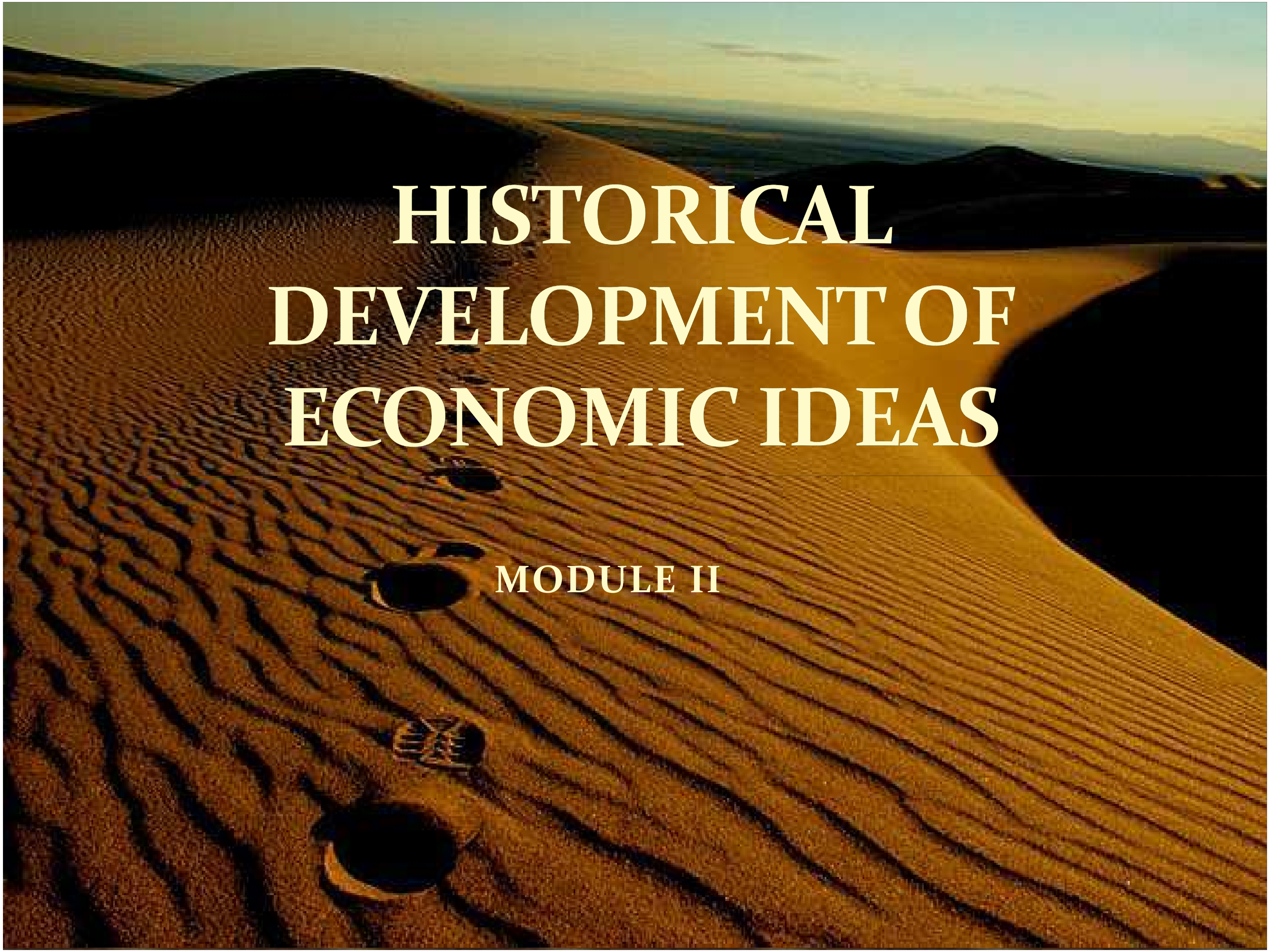

Footprints
in the
sands of time
are never made
sitting down.


HISTORICAL DEVELOPMENT OF ECONOMIC IDEAS
MODULE II

# OUTLINE

- The Various Economic Ideas
- The Development of Economic Science
- Pre-Classical Era of Economic Thought
- Classical Economics
- Notable Economists and Their Contributions
- Post-Classical Economic Ideas

# INTRODUCTION

- Development of Ideas in Economics finds its root in the History of Economic Thought
- History of Economic Thought is the study of economic of philosophy of economic philosophers
- We examine the contributions of great economists to the HET
- HET chronicles the economic activities of man from the STONE AGE; in his attempt to overcome scarcity, mode of trade, value, usury, the barter system and achieve his economic goals

- The Early man was preoccupied with the satisfaction of his basic needs
- Over time his focus has expanded
- With man changing development also came changes in practices and theories

1. In the Middle Ages for instance USURY (Interest) was termed EVIL (interpreted as using money to make money

- However, development of ideas and practices resulted in the legalisation of interest in the modern economy
- It is thus important that we study how economic thinking evolved over time as this will help situate us in the current state of affairs

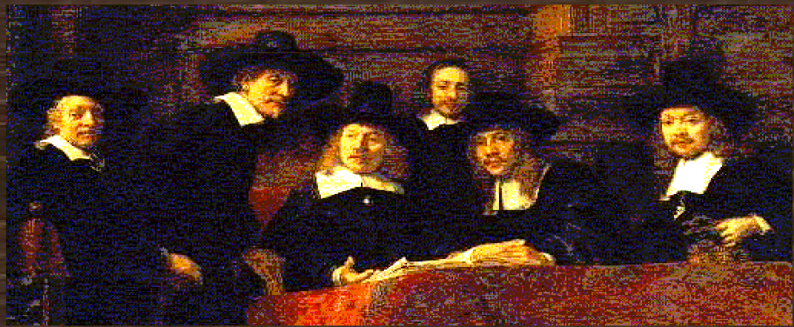
# Evolution of Economic Ideas

- The genesis of economic Ideas is traceable to the days of civilization
- In man's early stage of development economic problem was relatively small and limited
- This is in contrast to the enormity and complexity of the economic problem of man today
- Production systems in the early stage and middle ages was simplified
- This is the result because man was basically subsistent in his approach to production
- Nevertheless economic ideas were present in the simplicity of the ages

- The simplicity in economic activities of man in the early stage thus led to a slow development of economic theory
- Economic theory developed gradually through a mix of politics, logic, ethics, religion and moral philosophy
- Man in the early stage of development was a travelling animal who could survive in any environment, thus economic phenomena did not command much of his attention
- Through the phases of development of man, he had evolved into an economic entity

# DEVELOPMENT OF ECONOMIC SCIENCE

- Interest in economics dates back to Greek philosophers who dealt with some economic issues
- The English MERCANTILISTS in the 12$^{th}$ century wrote tracts and pamphlets on areas such as
  - Wealth
  - International Trade
  - Trade Barriers



- Germans developed a science in which economic and political measures were blended for the purpose of developing a self-sustained economy

- The contributions of the Greek philosophers and Mercantilist ideas to economic thought are notable
- However, Adam Smith was first to make a comprehensive attempt at packaging materials on Economic Science in his classic treatise

  An Enquiry in the Nature and Causes of the Wealth of Nations which was published in 1776
- Adam Smith employed his observations and description of economic activities to form the body of theory known as ECONOMIC PRINCIPLES
- Adam Smith's Wealth of Nations is thus **the genesis of Modern Economic Science**

AN

# INQUIRY

INTO THE

# Nature and Cauſes

OF THE

# WEALTH OF NATIONS.

By ADAM SMITH, LL.D. and F.R.S.

Formerly Profeſſor of Moral Philoſophy in the Univerſity of GLASGOW.

VOL. II.

---

LONDON:

PRINTED FOR W. STRAHAN; AND T. CADELL, IN THE STRAND.

MDCCLXXVI.

# Greek Contribution to the Development of Economic Thought

- Ancient Greece was at the centre of many things in human civilization
- Greeks developed expertise in Art, Literature, Sculpture, Philosophy and Government
- Greeks in the early life were nomadic and settled in Aegean, which turned out to be one of the centres of civilisation
- The people who dwelt in this area were from Asia Minor and Africa
- They developed skills in Metal Craft, Pottery, Glass Making, Weaving and the Act of Trade and Commerce

- Though the Greeks contributed immensely to every branch of human knowledge, they paid relatively more attention to the political economy
- Thus, Greek Economics is bound up with ethics and political science
- The economic thought of the Greeks is found in the writings of foremost and famous Greek philosophers
  - Plato and
  - Aristotle

# PLATO

Plato

and the Republic

# Plato's Contributions

- Born in Athens, Greece (427-327BC)
- At age 25 he became friend and pupil of Socrates
- At the death of Socrates, he left Athens and travelled round through Europe and North Africa
- He returned to Athens and established a school called 'Academy'
- He thought Mathematics and Philosophy there till his death
- His reputation was established via the publication of his The Republic

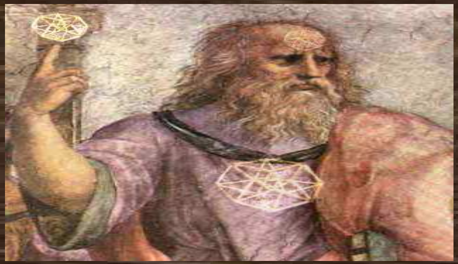
- In his writing, he conceptualized the IDEAL STATE
- He analysed

– Justice

The ideal state which will help in the realisation of justice

The idea of good and

A criticism of the constitution of state



- He saw the ideal state as one where philosophers would rule; while private property and family system would be abolished
- His ideal state is to be ruled by collectivist philosopher kings who are trained in the act of governance

# Division of Labour, State Creation and the Ideal State

- Plato's thoughts on division of labour was what Adam Smith and Hutcheson refined in their conceptualisation of productivity
- According to Plato, Division of labour is the main cause of the creation of a state

- In his words "Division of labour is as a result of the individuals inability to satisfy his manifold wants"; Given that no man could be self sufficient
- Thus, since individuals have many wants, many individuals have to be engaged to produce and supply the wants

- The conglomeration of a body of partners and helpers thus he termed a state
- The inhabitants of the state exchange with one another; one gives and another receives under the assumption that the exchange is promoting the good of the other
- He posited for an IDEAL STATE where justice and fair play reign, making it easy for good and bad to be identified
- In the State, common living for all is practised
- His system forbade the family system, as the state would take up the child from its birth. (children becoming state property
- He advocated communal ownership of land and properties ( in this regard he is regarded as the first communist)

# ARISTOTLE

# Aristotle (354 – 322BC)

- From the age of 17 he became a student of Plato and emerged Plato's most distinguished student
- He emerged the greatest scholar of the Greek period
- He founded so many sciences and is termed the first analytical economist
- He made groundbreaking contributions in ethics, logic, metaphysics, politics, rhetoric, history, psychology and natural science
- King of Macedonia appointed Aristotle as a tutor for his son who later became Alexander the Great
- Aristotle departed from looking at Plato's Ideal state instead conceptualising the evolution of the state

- In the evolution of a state, there was the

1. The family
2. Several families combining to form a village
3. Several villages formed into a state, provided the combination was large enough to be self sufficient

- He argued for private property and criticized Plato's communism
- He posited that private property gives people the opportunity to practice the virtues of benevolence and philanthropy
- He however disregarded the act of money making
- He posited that monetary trade and retail commerce was immoral and 'UNNATURAL'
- Aristotle's contributions to economic thought are unparalleled by any philosopher and came closer than any in developing a distinct science of economics

# The Middle Age and the Schoolmen

- The middle age spans over from the fall of the Roman Empire in AD476 – about 1500
- Following 500 years of civilization, the Roman Empire fell due to some economic and social, political consequences
- Following the fall of the Roman Empire  was the Rise of Christianity and Economic Recovery of the middle ages

# CHRISTIANITY in ANCIENT ROME

# The Rise of the Christian Faith

- The teachings of the Christian faith were legalized by a decree
- The teachings injected insight and hope for the population that had hitherto lived in fear
- Thus, Christianity grew in strength and affluence and spread over Europe
- This development led to the establishment of churches and monasteries- which became centres of learning and development of statesmanship
- The Church taught the dignity and brotherhood of man, denounced exploitation of the underpriviledged and condemned slavery
- The Christian teachings contrasted with the Greek philosophy which favoured slavery and inequality

- The Church taught about life after death and the rewards for good and evil
- The teachings resulted in a peaceful society and harmonious development among men

Other Consequences of the Teachings

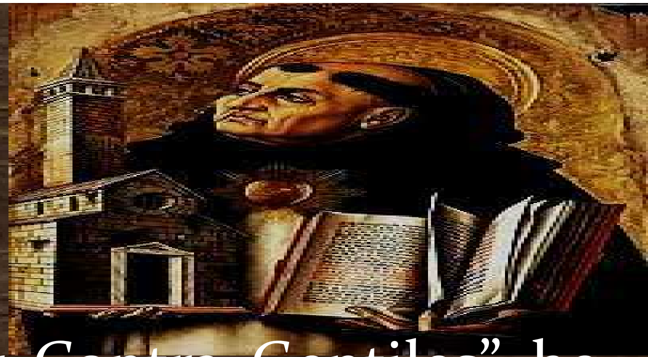
- The church owned the best land, houses, industries and adjoining businesses- thus, monasteries became the centre of economic control
- The church growth influenced the rise of economic activities which necessitated the enactment of laws regulating trade and exchange, commerce, credit and money lending.
- Loans were made on interest, bills of exchange used in trade and profits made from business transactions

- This period laid the foundation of modern day capitalism
- Following was the introduction of sophisticated money and establishment of price economy
- Ownership of tools of production became distinguished from the use of tools. This results in the introduction of corporate system of production
- A debate went on among Catholic and Protestants on what should constitute the 'Just Price' in a market economy
- The church advocated that price of goods must of a necessity cover the cost of production
- Thus, the concept of a fair wage became based on a wage system that was sufficient to maintain each worker at his station of life

# The Schoolmen

- Following the rise of economic activities intellectuals in the Catholic church began discussion on issues which impacted on the society;
- just price,
- just wage,
- the legitimacy of interest and profit
- Value and distribution etc
- Prominent of the Intellectuals was St Thomas Aquinas

# St. Thomas Aquinas



- In his most important work “summer Contra Gentiles” he attempt to harmonize Christianity with Aristotelian philosophy
- He defended trade and commerce as well as the ownership of private property
- He condemned communism, usury, unjust price and unjust wage
- On Usury, he condemned the act of the church charging interest rate on loans; seeing this as morally wrong
- He held that a person is entitled to income because he risked something for it, but since a borrower makes profit out of the fruit of his own labour and not as a fruit of the loan, the lender is not entitled to income

- Just Price and Value

  He held that all goods be sold at just price, one which is sufficient to maintain the seller at his customary standard of living

- If price was just, then trade was morally justifiable, especially if it contributed to the common good and insured equal advantage to both parties

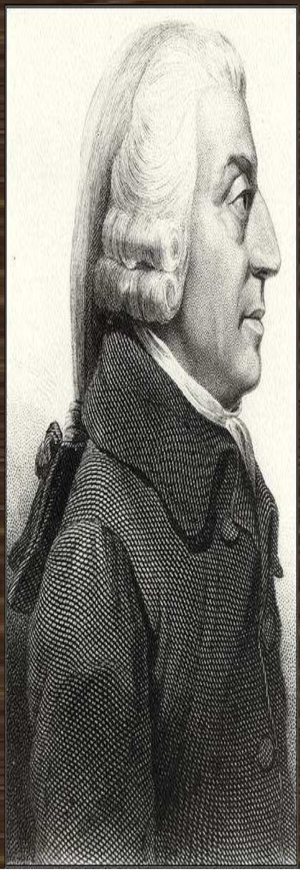
- On wages

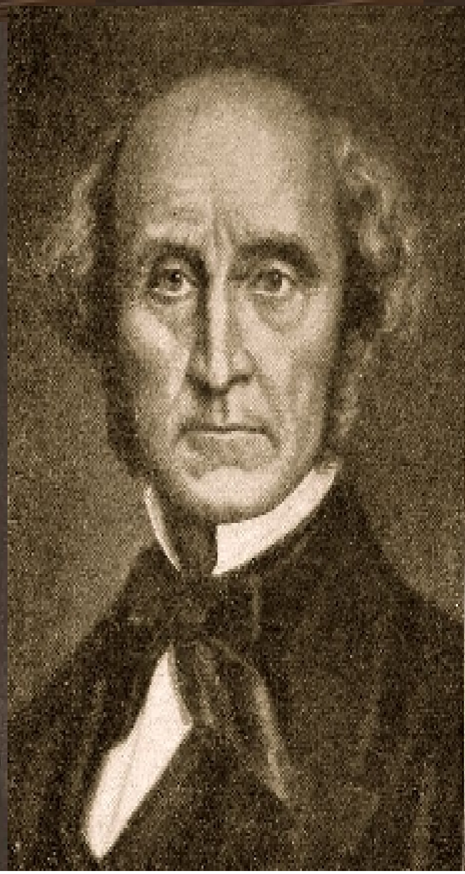
  A labourer is worthy of his hire (Lk 10:7; 1 Tim 5:18)

  From the concept of justice therefore, a wage paid a worker should enable him maintain his standard of living

# CLASSICAL ECONOMICS

- A tradition of economic thought originated in the works of Adam Smith and developed through the work of David Ricardo, John S. Mill and Thomas R. Malthus

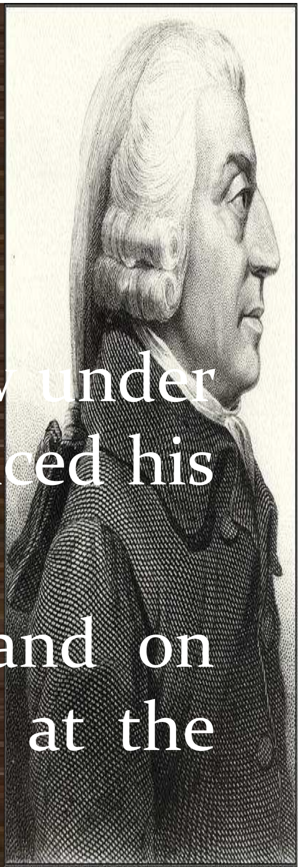





- French Physiocrats emphasized the place of agriculture in the economy.
- It was their stance it was the source of all economic wealth
- Smith was in disagreement with this view instead drawing attention to the development of manufacturing and importance of labour productivity asserting that ultimately labour was the true measure of value
- The presumption of COMPETITION was the foundation of classical thought

- Classicals believed that though individuals were motivated by self-love and personal ambition, free competition ensured that the whole community as a whole benefited
- In the very words of Adam Smith “It is not from the benevolence of the butcher that we expect our dinner, but from (his) regard to his (own) interest.
- In classical Economic analysis, SELF-INTEREST was the dominant explanation of economic activity
- The classicals therefore held that government interference in economic activity to be kept at the barest minimum

# ADAM SMITH (1723-1790)



- Born in Scotland
- Studied from 1737-1740 at the University of Glasgow under Francis Hutcheson (1694- 1746) who greatly influenced his thought
- 1740-1746 Studied at the Universisty of Oxford and on account of poor academic state of the university at the time, he depended mainly on personal effort
- On return to Scotland he taught for some time in Edinburgh
- Published *Theory of Moral Sentiments in 1759 and gained wide recognition*
- Became the tutor of the Duke of Buccleuch, son-in-law of Charles Townsend, the then Chancellor of the Exchequer

- The job which provided him sufficient income and economic security as a scholar
- Smith toured Europe with the Duke and in the process came in contact with the PHYSIOCRATS
- He was greatly influenced by their learning and logic
- Smith Published his best-known work *An inquiry into the Nature and Causes of the Wealth of Nations in 1776*
- He had so many other works which he burnt publicly in the presence of his friends
- Smith was appointed Commissioner of Customs at Edinburgh, a post he held till his death in 1790

# General Philosophy of Smith

- According to Smith, Human actions were actuated by:

- Self-love
- Sympathy
- Desire to be free
- A Sense of Propriety
- A Habit of Labour
- The Propensity to Truck, Barter and Exchange one thing for another

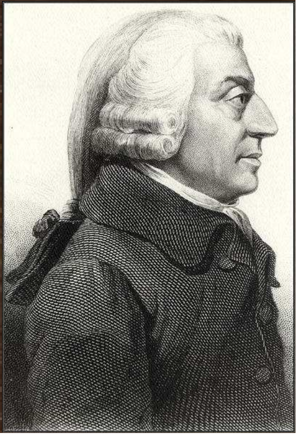
Given this he came to several conclusions

- Everyone is bound to act on the basis of self-interest. This explains the classical notion of economic rationality of the economic man. There is an invisible hand guiding the behaviour of every economic unit
- Everyone seeks to improve his condition
- Everyone is the best Judge of his own interests; the state or any other agency is not competent to judge that on behalf of others
- The interests of the different economic units went in harmony and are never in conflict at all

\- The butcher and the baker in the promotion of their own selfish interests furthered those of society also

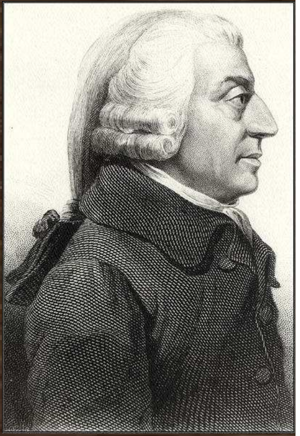
# Smith and the Role of the State

- Adam Smith was not in the support of government interference in the workings of the economy.
- The rationale behind this is to allow the individual (who is the best judge of his self-interest) operate freely
- To Smith, the role of the government should be limited to the following
- Administration of justice
- Provision of national defense
- Provision and maintenance of 'public goods'

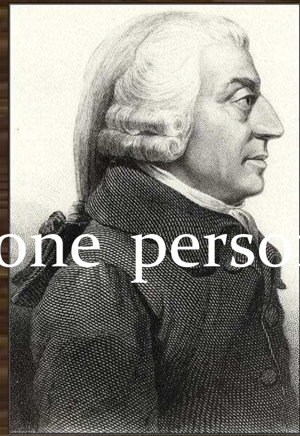


# Adam Smith and Division of Labour

- Man always seeks a change, variety and greater perfection
- "Such is the delicacy of man alone, (and) that no object is produced to his liking. He finds that there is need for improvement"
- This thought formed the basis for division of labour
- He noted that the question of self sufficiency is eroded gradually with economic progress



- Smith illustrated this with the making of a pin and showed that division of labour gives rise to increased production due to



- Dexterity of labour
- The saving of time lost in passing from one person to another
- The invention of Machines

- Adam Smith does not believe division of labour is the result of human planning or variations in basic capacities of different individuals. He held that it flows from a propensity in human nature for man to barter with another, which is common to all men and unknown to no other animal

- Also, Smith maintained that division of labour must be proportional to the extent of commerce or to the size of the market
- The industrial revolution was just at the corner at the time of the writing of Adam Smith’s Wealth of Nations and this changed the general attitude towards trade and commerce
- Then the society grew beyond the concern for economic justice and the status quo of the middle ages towards a concern for economic growth and change
- The evolutionary changes brought about the abandonment of feudalism and mercantilist restraint of trade and commerce

# Smith and the Natural Order

- Smith gave the idea of a self-regulating economy operating within a market system an eloquent expression
- He provided a framework for analyzing the question of income growth, value and distribution
- The questions he posed constituted a sufficient material for economists to debate for at least a century after his demise
- Smith is fondly referred to as the FATHER of economics as he succeeded in weaving his contributions with those of his predecessors into a comprehensive treatise that was greater than the sum of its parts


JEREMY
BENTHAM

# JEREMY BENTHAM (1748- 1832)

- The principle of utility (self-interest) is closely associated to Jeremy Bentham
- His utilitarianism was based on the ethical doctrine that human conduct should be directed towards maximizing the happiness of the greatness of people
- He wrote *Introduction to the Principle of Morals and Legislation (1789)*

"Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do as well as to determine what we shall do"

- According to him, human economic welfare can be measured by summing up of collective pleasure and pains

- The circumstances by which the value of pain and pleasure are to be measured include the following factors:

i. The intensity of pleasure and pain
ii. The duration of pleasure and pain
iii. Its certainty or uncertainty
iv. Its remoteness
v. Its fecundity (pleasure followed by more pleasure or pain followed by more pain)
vi. Its purity (e.g. Childbirth has a low index of purity because it represents a mix of pain and pleasure
vii. Its extent (the number of people affected by it)

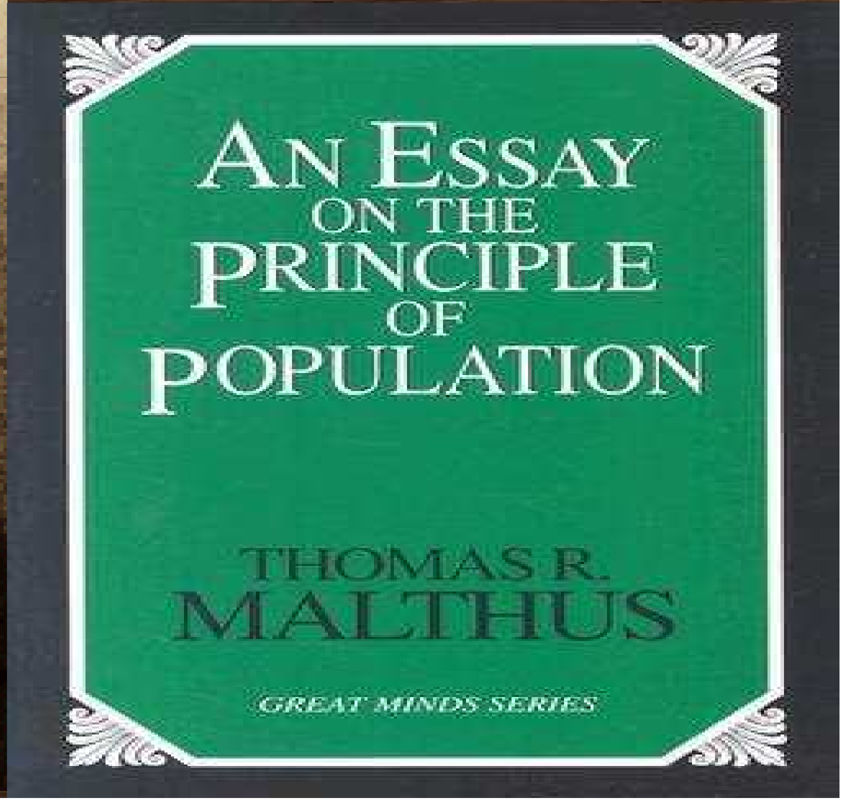
- Just as self-interest is the key ingredient of Smith's economic liberalism, it is the key ingredient of Bentham's utilitarianism

- However, while Smith relied on the natural identity of interest to harness the consequences of self-interest, Bentham held that intervention is justified in order to forge an artificial identity of interests especially in spheres of human activity where unrestrained individual interests clash with that of the wider public

- For example the selfish interest of the thief, if allowed free play, violates the individuals interests and security of law-abiding citizens

- Thus, Bentham devoted attention to the prospect of controlling deviant behaviour through administrative arrangement devised to discourage potential miscreants from engaging in antisocial behaviour.

# THOMAS MALTHUS



# THOMAS MALTHUS (1766- 1834)

- Was the economist who gave the classical population theory
- He published *An Essay on the Principle of Population as It Affects the Future Improvement of Society anonymously*
- He is also known for his *theory on economic crisis*
- His essay on population was a reaction to the extreme optimism of some philosophers who predicted the elimination of all social evils from society believing in the impending emergence of a society devoid of war, crime, government, disease, anguish and resentment, where every man unflinchingly sought the good of all.

- Malthus essay stated that the biological capacity of man to reproduce will, if left unchecked, outstrip the physical means of subsistence, in effect, rendering the perfectibility of human society impossible

- Malthus Principle of Population was based on two propositions

(i) Population, when left unchecked, increases in a geometrical progression of such a nature as to double itself every twenty-five years

(ii) Even under the most favourable conditions, the means of subsistence (food supply) cannot possibly increase faster than in arithmetic progression

- Malthus did not believe that population would reach an alarming, however that there is some natural law which forces the increase in population at a faster rate than the increase in food supply

The natural Laws are highlighted

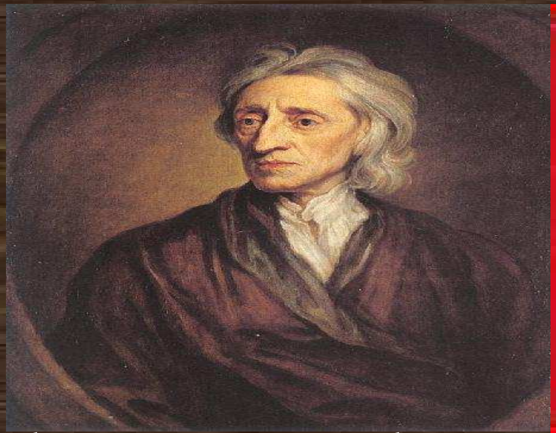
i. The need for procreation is a powerful instinct in human beings
ii. The means of subsistence (supply of food) cannot increase that fast (geometric progression) due to the niggardliness of nature. (Agric output is subject to the law of diminishing returns)
iii. Irrespective of the exact rates at which population and the means of subsistence were increasing, so long as they conform to their respective rates of growth, population is bound to outstrip food supply
iv. Unless population is checked through preventive checks, it was bound to be kept within limits by the positive checks

| PREVENTIVE CHECKS | POSITIVE CHECKS |
| --- | --- |
| These are efforts put in place by man to check the undesirable consequences of rapid population growth.<br>They include:<br><br>Late Marriage<br>Celibacy<br>Moral Restraints within Marriage | These are methods engaged by nature to bring under the control the rate of population growth. These methods include:<br><br>Floods<br>Droughts<br>Famines<br>Reduced Life Span<br>Diseases<br>War<br>Epidemics |

# CLASSICAL MONETARY THEORY

- An earlier strand of classical thought asserted that money stimulates trade thus emphasizing the effect of money on output and employment, while ignoring the possible relationship between money and prices. This was attributed to John Law, Jacob Vanderlint and George Berkeley

- Classical monetary theory is found on the works of John Locke (1632-1704); Richard Cantillon (1685-1734);David Hume (1711-1776).

They were the proponents of the quantity theory of money concentrated on the relationship between money and prices. The quantity theory of money provided an analytical structure for understanding and explaining changes in aggregate price levels.

- The concept of neutral money emerged from the writings of David Hume

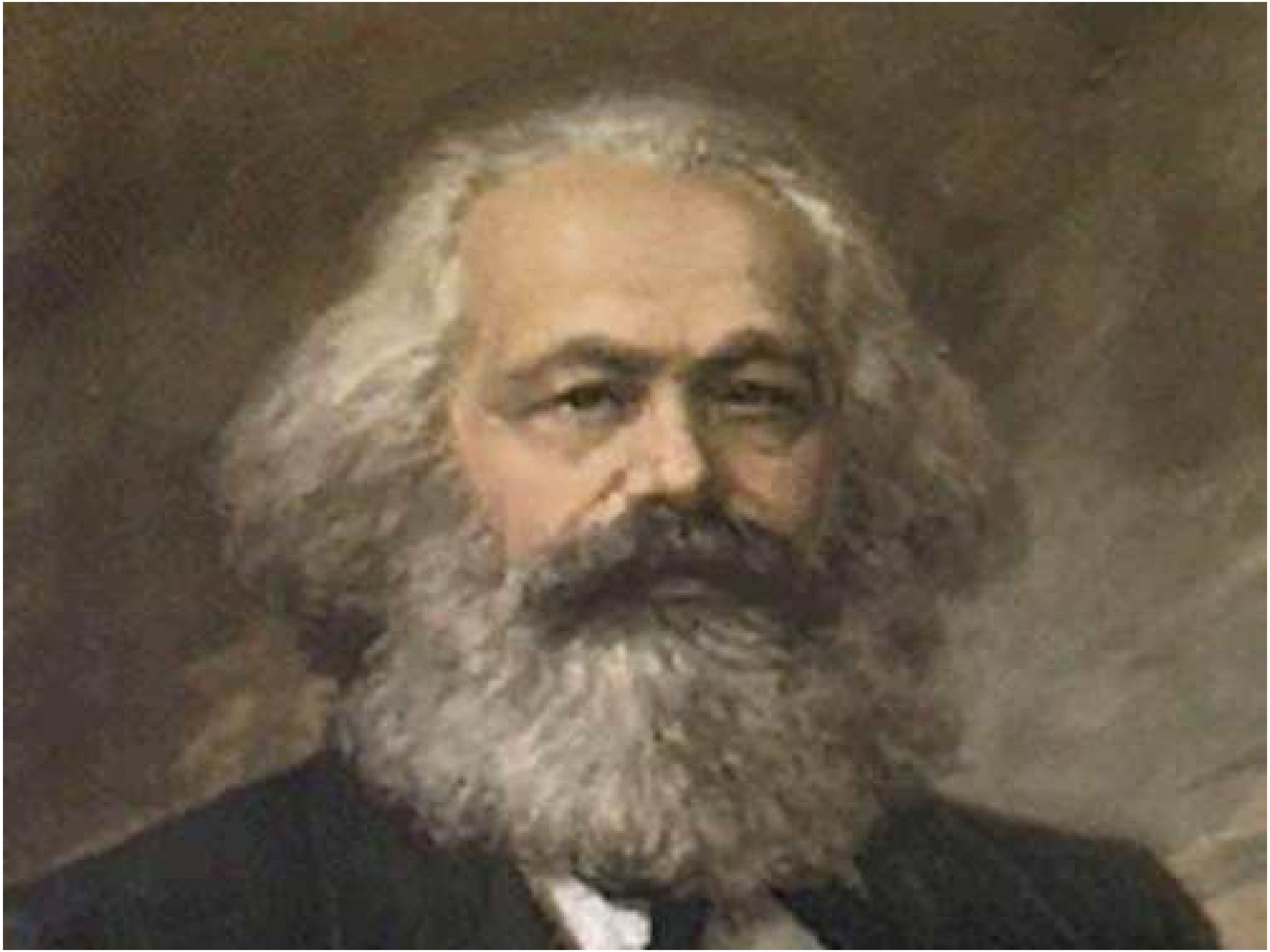
# DAVID RICARDO

# DAVID RICARDO (1772- 1823)

- Son of Jewish parents who were connected with the money market
- At age 14 he was already working in the money market
- He made a fortune on the stock exchange retiring at age 42
- His early writings were on money and banking
- He published several pamphlets. However, his most important work was *The Principles of Political Economy and Taxation which was first published in 1817*
- In his *Principles,* Ricardo was basically concerned with how to determine the laws that regulate the distribution between the different classes of landowners, capitalists and labour, of the produce of industry

# RICARDO'S CRITICS

- Ricardo had so manv supporters following the publication *of his Principles.*
- John Ramsay McCulloch, James Mill, and Thomas DeQuinccy were some of Ricardo's staunch supporters.
- However, Ricardo also had his critics and two of his foremost critics were Thomas Maltlius and Nassau Senior.
- Their disagreement stemmed basically from the Corn Law controversy and the economic methods adopted by both groups.



# THE POST-CLASSICAL ERA

## Marxian Economics

- Karl Marx provided a fundamental critique of classical economics, based on the labour theory of value.
- Just as the term "mercantilism" had been coined and popularised by its critics, like Adam Smith, so was the term "capitalism" or *Kapitalismus* used by its dissidents, primarily Karl Marx.

# Karl Heinrich Marx, (1818–1883)

- German-born philosopher, sociologist, journalist and leading classical economist.
- Born in Trier, the son of a prosperous lawyer, he was educated at the University of Bonn (briefly) and at the University of Berlin where he received a doctorate in 1841 for his research into post-Aristotelian Greek philosophy.
- His interest in socialism was first aroused by conversations with Baron von Westphalen, whose daughter Jenny he was later to marry;
- His taste for metaphysics was stimulated by involvement in the Young Hegelian Group from 1837.

- His career as a journalist began with his editing of the liberal paper Rheinsche Zeitung from October 1842;
- His interest in economics dates from his residence in Paris in 1844 where he had migrated to study contemporary French socialism.
- He turned to SMITH, RICARDO and JAMES MILL to obtain an analytical training to tackle what was to be his life-long research project, CAPITALISM.
- He met Friedrich ENGELS, who was to be until death his collaborator and on many occasions, financial supporter, in Paris.
- After a three-year sojourn in Brussels he visited England to see at first hand the most advanced industrial country.

- He spent some periods in Paris and Cologne in 1848–1849 to participate in the socialist movements which sprang up at the time of the 1848 European revolutions,
- He spent the rest of his life in London financially precarious and incessantly acquiring in the British Museum Reading Room the masses of knowledge which fuelled his analysis of history and society.
- His contribution to economics appears in Grundrisse (1857–1858), Das Kapital (1867, 1885 and 1894) and Theories of Surplus Value (1905–10).
- Many of the ideas in his works had long been discussed by classical economists, e.g. value in use and value in exchange, the decline in the rate of profit and labour as a basis of value.
- All these ideas he has formed in a powerful new synthesis.

- This consisted of the
- TURGOT–SMITH stages theory, an analysis of the circulation of money and of commodities and his examination of the determinants of SURPLUS VALUE to expose the defects of capitalism in a way unparalleled in economics.
- Marx also had critics, particularly because many of his prophecies were unfulfilled with respect to the collapse of capitalism and the increasing IMMISERATION of the working class.

- Marx realized that the TRANSFORMATION PROBLEM was a major challenge to his value and price theories: devotees since his death have tried to solve it but their proposed solutions usually require so many restrictive assumptions as to make their results trivial.
- Whatever may have been his defects as an economic theorist, his influence has been massive with thousands of academic disciples throughout the world determined to study economics in a sociological and ideological context.

# Neoclassical economics

- Neoclassical economics is conventionally dated from William Stanley Jevons's *Theory of Political Economy* (1871),
- Carl Menger's *Principles of Economics* (1871), and Leon Walras's *Elements of Pure Economics* (1874 – 1877).
- These three economists have been said to have promulgated the marginal utility revolution, or Neoclassical Revolution
- Historians of economics and economists have debated:
- Whether utility or marginalism was more essential to this revolution (whether the noun or the adjective in the phrase "marginal utility" is more important)

- Whether there was a revolutionary change of thought or merely a gradual development and change of emphasis from their predecessors
- Whether grouping these economists together disguises differences more important than their similarities.
- In particular, Walras was more interested in the interaction of markets than in explaining the individual psychology.
- Jevons saw his economics as an application and development of Jeremy Bentham's utilitarianism and never had a fully developed general equilibrium theory.
- Menger emphasized disequilibrium and the discrete. Menger had a philosophical objection to the use of mathematics in economics.

# Carl Menger(1840-1921

- An Austrian economist stated the basic principle of marginal utility in his, *Principles of Economics*(1871). Consumers act rationally by seeking to maximise satisfaction of all their preferences.
- He posited that people allocate their spending so that the last unit of a commodity bought creates no more satisfaction than a last unit bought of something else.

# Stanley Jevons (1835-1882)

- He was Menger's English counterpart,
- Worked at University College, London
- He emphasized in the *Theory of Political Economy* (1871) that at the margin, the satisfaction of goods and services decreases.
- An example of the theory of diminishing returns is that for every orange one eats, the less pleasure one gets from the last orange (until one stops eating).

# Leon Walras (1834-1910),

- He generalized marginal theory across the economy in *Elements of Pure Economics* (1874).
- He was of the stance that small changes in people's preferences ,for instance shifting from beef to mushrooms, would lead to a mushroom price rise, and beef price fall;
- Thus stimulates producers to shift production, increasing mushrooming investment, which could increase market supply leading to a new lower mushroom price and a new price equilibrium between the products.
- Walras adopted a set of strict assumptions, that markets were competitive and that goods were produced under constant returns to scale but future developments at constructing general equilibria would dispense with these assumptions.

# Alfred Marshall(1842-1924)

- Is credited with an attempt to put economics on a more mathematical footing.
- He was the first Professor of Economics at the University of Cambridge
- His work, *Principles of Economics* coincided with the transition of the subject from political economy to his favoured term, "economics".
- Marshall viewed mathematics as a way to simplify economic reasoning, though he had reservations, revealed in a letter to his student Arthur Cecil Pigou.
-

"(1) Use mathematics as shorthand language, rather than as an engine of inquiry.

(2) Keep to them till you have done.

(3) Translate into English.

(4) Then illustrate by examples that are important in real life.

(5) Burn the mathematics.

(6) If you can't succeed in 4, burn 3. This I do often."[61]

- Coming after the marginal revolution, Marshall concentrated on reconciling the classical labour theory of value, which had concentrated on the supply side of the market, with the new marginalist theory that concentrated on the consumer demand side.
- Marshall's graphical representation is the famous supply and demand graph, aka "Marshallian cross".
- He insisted it is the intersection of *both* supply *and* demand that produce an equilibrium of price in a competitive market.
- Over the long run, argued Marshall, the costs of production and the price of goods and services tend towards the lowest point consistent with continued production.

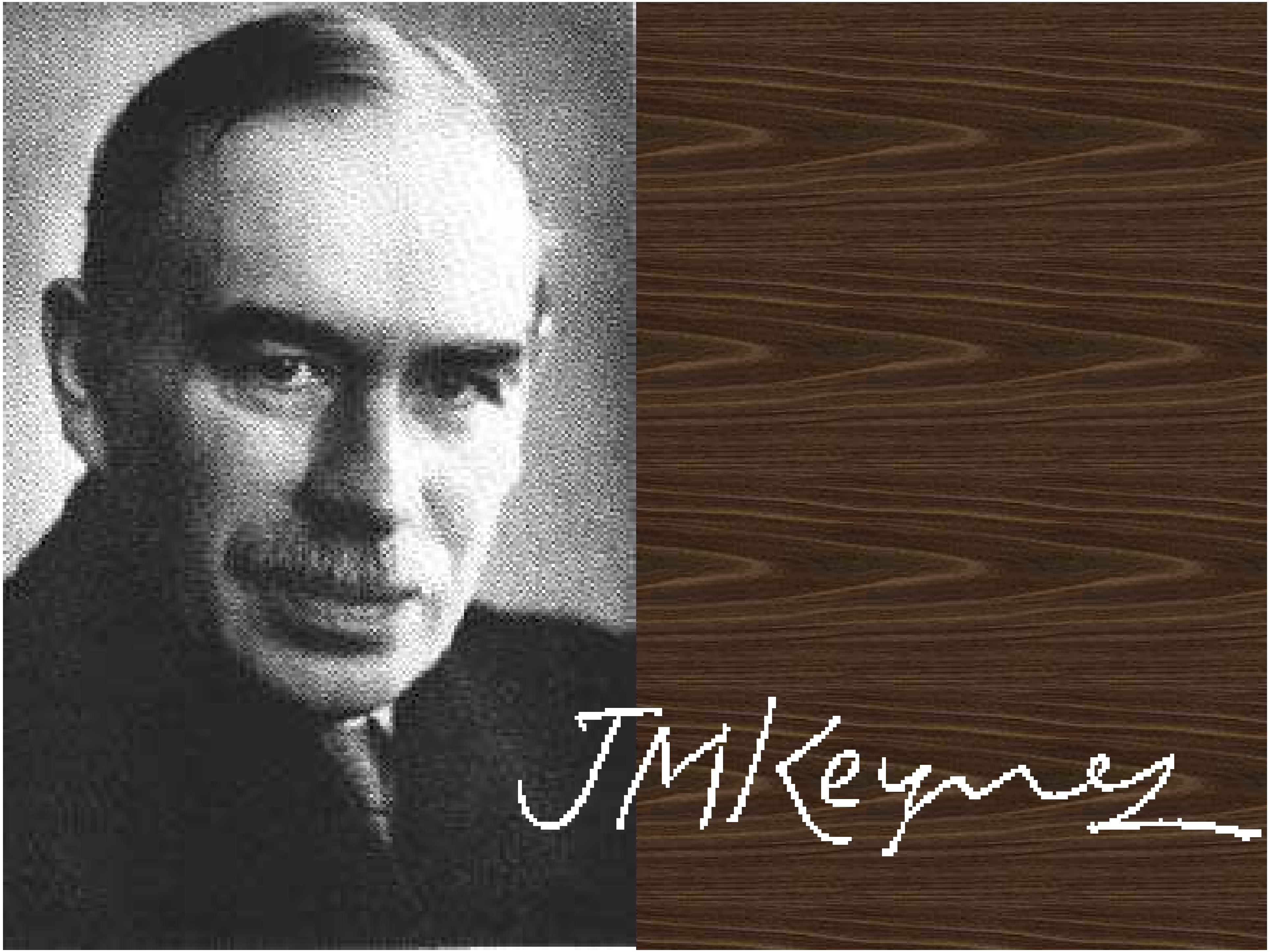
# Collapse and reconstruction

- Alfred Marshall was still working on his last revisions of his *Principles of Economics* at the outbreak of the First World War (1914-1918).
- The new twentieth century's climate of optimism was soon violently dismembered in the trenches of the Western front, as the civilised world tore itself apart.
- For four years the production of Britain, Germany and France was geared entirely towards the war economy's industry of death.
- In 1917 Russia crumbled into revolution led by Vladimir Lenin's Bolshevik party. They carried Marxist theory as their saviour, and promised a broken country "peace, bread and land" by collectivising the means of production.

- Also in 1917, the United States of America entered the war on the side of France and Britain, President Woodrow Wilson carrying the slogan of "making the world safe for democracy".
- He devised a peace plan of Fourteen Points. In 1918 Germany launched a spring offensive which failed, and as the allies counter-attacked and more millions were slaughtered, Germany slid into revolution, its interim government suing for peace on the basis of Wilson's Fourteen Points.
- Europe lay in ruins, financially, physically, psychologically, and its future with the arrangements of the Versailles conference in 1919.
- John Maynard Keynes was the representative of Her Majesty's Treasury at the conference and the most vocal critic of its outcome.

# Keynesian Economic Theory

- This is an economic theory based on the ideas of twentieth-century British economist John Maynard Keynes.
- **John Maynard Keynes** (1883-1946) was born in Cambridge, educated at Eton and supervised by both A. C. Pigou and Alfred Marshall at Cambridge University.
- He began his career as a lecturer, before working in the British government during the Great War, and rose to be the British government's financial representative at the Versailles conference.
- During the Great Depression, Keynes had published *The General Theory of Employment, Interest, and Money* (1936).


JMKeynes

- The depression had been sparked by the Wall Street Crash of 1929, leading to massive rises in unemployment in the United States, leading to debts being recalled from European borrowers, and an economic domino effect across the world.
- Orthodox economics called for a tightening of spending, until business confidence and profit levels could be restored.
- Keynes by contrast, had argued in *A Tract on Monetary Reform* (1923) that a variety of factors determined economic activity, and that it was not enough to wait for the long run market equilibrium to restore itself.
- As Keynes famously remarked, "...this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again."
-

- The state, according to Keynesian economics, can help maintain economic growth and stability in a mixed economy, in which both the public and private sectors play important roles.
- Keynesian economics seeks to provide solutions to the failures of laissez-faire economic liberalism, which advocates that markets and the private sector operate best without state intervention.
- In Keynes's theory, some micro-level actions of individuals and firms can lead to aggregate macroeconomic outcomes in which the economy operates below its potential output and growth.

- Many classical economists had believed in Say's Law, that supply creates its own demand, so that a "general glut" would therefore be impossible.
- Keynes contended that aggregate demand for goods might be insufficient during economic downturns, leading to unnecessarily high unemployment and losses of potential output.
- Keynes argued that government policies could be used to increase aggregate demand, thus increasing economic activity and reducing high unemployment and deflation.
- Keynes's macroeconomic theories were a response to mass unemployment in 1920s Britain and in 1930s America.

- Keynes argued that the solution to depression was to stimulate the economy ("inducement to invest") through some combination of two approaches :
- a reduction in interest rates.
- Government investment in infrastructure - the injection of income results in more spending in the general economy, which in turn stimulates more production and investment involving still more income and spending and so forth.
- The initial stimulation starts a cascade of events, whose total increase in economic activity is a multiple of the original investment.
- A central conclusion of Keynesian economics is that in some situations, no strong automatic mechanism moves output and employment towards full employment levels.
- This conclusion conflicts with economic approaches that assume a general tendency towards an equilibrium

# Monetarism

- Is a school of economic thought concerning the determination of national income and monetary economics.
- It focuses on the supply of money in an economy as the primary means by which the rate of inflation is determined.
- Monetarism today is mainly associated with the work of Milton Friedman, who was among the generation of economists to accept Keynesian economics and then criticize it on its own terms.

- The central issue for the monetarists was that the economics of supply and demand didn't leave any role for fiscal policy and aggregate demand at all
- However, it still seemed possible that government policy might influence production by changing the money supply -- by monetary policy.
- Friedman and Anna Schwartz wrote an influential book, *Monetary History of the United States 1867-1960*, and argued that "**inflation is always and everywhere a monetary phenomenon**."
- Friedman advocated a central bank policy aimed at keeping the supply and demand for money at equilibrium, as measured by growth in productivity and demand.

- The monetarist argument that the demand for money is a stable function gained considerable support during the late 1960s and 1970s from the work of David Laidler.
- The European Central Bank officially bases its monetary policy on money supply targets.
- Critics of monetarism include:

- Neo-Keynesians who argue that demand for money is intrinsic to supply, and
- some conservative economists who argue that demand for money cannot be predicted.

- Also, Joseph Stiglitz has argued that the relationship between inflation and money supply growth is weak when the inflation is low.

# Rational Expectation Theory

- A view of how individuals form their EXPECTATIONS of the future values of economic variables was first advanced by **Muth in 1961** and is now a central pillar of NEW CLASSICAL ECONOMICS.
- They assume that when individuals are making decisions, they have all relevant information, including

  - knowledge of the structure of the economic system, and

  - any errors in the analysis of that information are attributable to random forces.
- This approach has been used to analyze asset markets, the business cycle and the natural rate of unemployment.

- There have been many criticisms of rational expectations, including
- questions about the assumption of rationality,
- the recurrence of economic processes and
- the adequacy of information.
- To assume rational expectations is to assume that agents' expectations are correct on average.

  In other words, although the future is not fully predictable, agents' expectations are assumed not to be systematically biased and use all relevant information in forming expectations of economic variables.
- This way of modeling expectations later became influential when it was used by Robert E. Lucas Jr and others.

- Modeling expectations is crucial in theories like
- New classical macroeconomics (i.e. new Keynesian macroeconomics, and the
- Efficient market hypothesis of contemporary finance which study the dynamics of the economy over time.
- For example, negotiations between workers and firms will be influenced by the expected level of inflation, and the value of a share of stock is dependent on the expected future income from that stock.
- Rational expectations theory defines this kind of expectations as being identical to the *best guess of the future* (the optimal forecast) that uses all available information.

- However, without further assumptions, this theory of expectations determination makes no predictions about human behavior and is empty.
- Thus, it is assumed that outcomes that are being forecast do not differ systematically from the market equilibrium results.
- As a result, rational expectations do not differ systematically or predictably from equilibrium results.
- That is, it assumes that people do not make systematic errors when predicting the future, and deviations from *perfect foresight* are only random.
-

- In an economic model, this is typically modeled by assuming that the expected value of a variable is equal to the value predicted by the model, plus a random error term representing the role of ignorance and mistakes.
- For example, suppose that *P* is the equilibrium price in a simple market, determined by supply and demand.
- The theory of rational expectations says that the actual price will only deviate from the expectation if there is an 'information shock' caused by information unforeseeable at the time expectations were formed.
- In other words ex ante the actual price is equal to its rational expectation:
- $P = P^* + e$ *and* $E(P) = P^*$ where P* is the rational expectation and *e* is the random error term, which has an expected value of zero, and is independent of $P^*$.

- Rational expectations theory is the basis for the efficient market hypothesis (efficient market theory).
- If a security's price does not reflect all the information about it, then there exist "unexploited profit opportunities": someone can buy (or sell) the security to make a profit, thus driving the price toward equilibrium.
- In the strongest versions of these theories, where all profit opportunities *have been* exploited, all prices in financial markets are correct and reflect market fundamentals (such as future streams of profits and dividends).
- Each financial investment is as good as any other, while a security's price reflects all information about its intrinsic value.